ASSISTING THE FARM CREDIT SYSTEM: AN ANALYSIS OF TWO BILLS

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PREFACE

The Farm Credit System is the nation's largest agricultural lender. Unless federal assistance is forthcoming, it will face a serious financial crisis in the near future. In response to a request by the Senate Budget Committee, this paper analyzes the effects of bills to assist the Farm Credit System passed by the House of Representatives and the Senate Committee on Agriculture. In keeping with the mandate of the Congressional Budget Office (CBO) to provide objective analysis, this report makes no recommendations.

This paper was written by David D. Trechter of CBO's Natural Resources and Commerce Division, under the supervision of Everett M. Ehrlich. Valuable comments were provided by Peter H. Fontaine, Roger E. Hitchner, and Christine M. Ross of the CBO, William Jeffrey Shipp of the Farm Credit Council, David Freshwater of the Joint Economic Committee, and Kris Allen of Resources for the Future. The manuscript was edited by Francis Pierce, typed by Gwen Coleman, and prepared for publication by Kathryn Quattrone.

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SUMMARY

The Farm Credit System (FCS), the nation's largest institutional lender to the agricultural sector, is in severe financial trouble. Federal assistance will be required if a crisis induced by the failure of some portions of the system is to be avoided. Such a crisis would adversely affect the agricultural sector and could spill over into other capital markets, particularly those served by other government-sponsored lenders such as those in the housing sector.

THE GENESIS OF THE PROBLEM

The problems of the FCS have arisen from a number of sources, among the most important of which are:

- Falling agricultural land values that have necessitated a dramatic increase in loan loss reserves, leading to an equally dramatic fall in the system's income;
- An unfortunate timing of bond sales in the late 1970s and early 1980s that left the system with a high cost of funds;
- A rapid expansion in the system's loan portfolio caused in part by more liberal lending practices; and
- An increase in the volume of nonaccrual loans resulting from a very weak farm economy.

In short, both internal mistakes and the impact of general economic factors have left the FCS at the brink of insolvency.

ACTIONS NEEDED TO RESTORE THE FCS

Efforts to rescue the FCS have focused on three goals that most observers consider of central importance:

- o Short-term system recapitalization;
- o Institutional flexibility;
- o Long-term viability.

System Recapitalization

Probably the most important short-term goal is to recapitalize the FCS--that is, to increase the collateral and equity in the system. By statute the FCS must have sufficient collateral, principally composed of performing loans, cash and investments, and the current market value of acquired property, to back all bonds and notes fully. In addition, it must have equity greater than zero, where equity consists of earned surplus and borrower capital. Failing to meet either of these conditions would preclude an institution from participating in system-wide bond issues. An institution incapable of issuing bonds would face liquidation, receivership, or conservatorship. The system also shares what is called "joint and several liability," meaning that the liabilities (notes and bonds) of one institution are ultimately the responsibility of all institutions within the FCS. Thus, if one bank is declared to be insolvent, the other institutions must satisfy the failing bank's obligations to its bondholders. Currently, two district-level institutions within the system have nearly exhausted their collateral. The equity position of parts of the system is also precarious: at the end of the third quarter of 1987, the Federal Land Banks had a total surplus of -$0.4 billion. Banks with negative equity have been able to continue operations only because the more liberal Regulatory Accounting Practices adopted in 1986 allow them to postpone recognition of certain expenses. Thus, the ability of the system to absorb additional losses is limited.

Institutional Flexibility

The country's financial system is becoming increasingly integrated and complex. At the same time, the laws governing banking in the United States may be revised in ways that will make banking more competitive. The FCS will have to meet this competition without losing sight of its mission. In weighing current legislation, two questions relating to the evolutionary flexibility of the system are of importance.

The first is whether the legislation will enable the FCS to respond to unforeseen market pressures.

A second issue concerns the balance between the social mission of the FCS (a cooperative dedicated to enhancing farmers' control over their supply of credit) and its commercial imperative (the need to be profitable). Both the House and the Senate bills seek to extend farmers' control over their supply of credit under the rubric of borrowers' rights. Two factors to be considered with respect to borrowers' rights are the equitability of providing FCS borrowers with rights not granted to all agricultural borrowers, and the impact of these new rights on the competitive position of the FCS.

Long-term System Viability and Access to Capital

The Congress has passed legislation dealing with the FCS's financial plight in each of the past two years. No one is anxious to make this an annual exercise. Therefore, both the House and the Senate bills contain provisions aimed at reducing the likelihood that federal assistance packages will be needed in future years. The ability of a lending institution to withstand a period of economic slowdown is directly related to its access to capital. This capital can be its own (for example, the capital reserves that commercial banks are required to maintain) or capital to which it has a claim (by virtue of an insurance policy or some other mechanism).

THE HOUSE AND SENATE APPROACHES TO THE PROBLEM

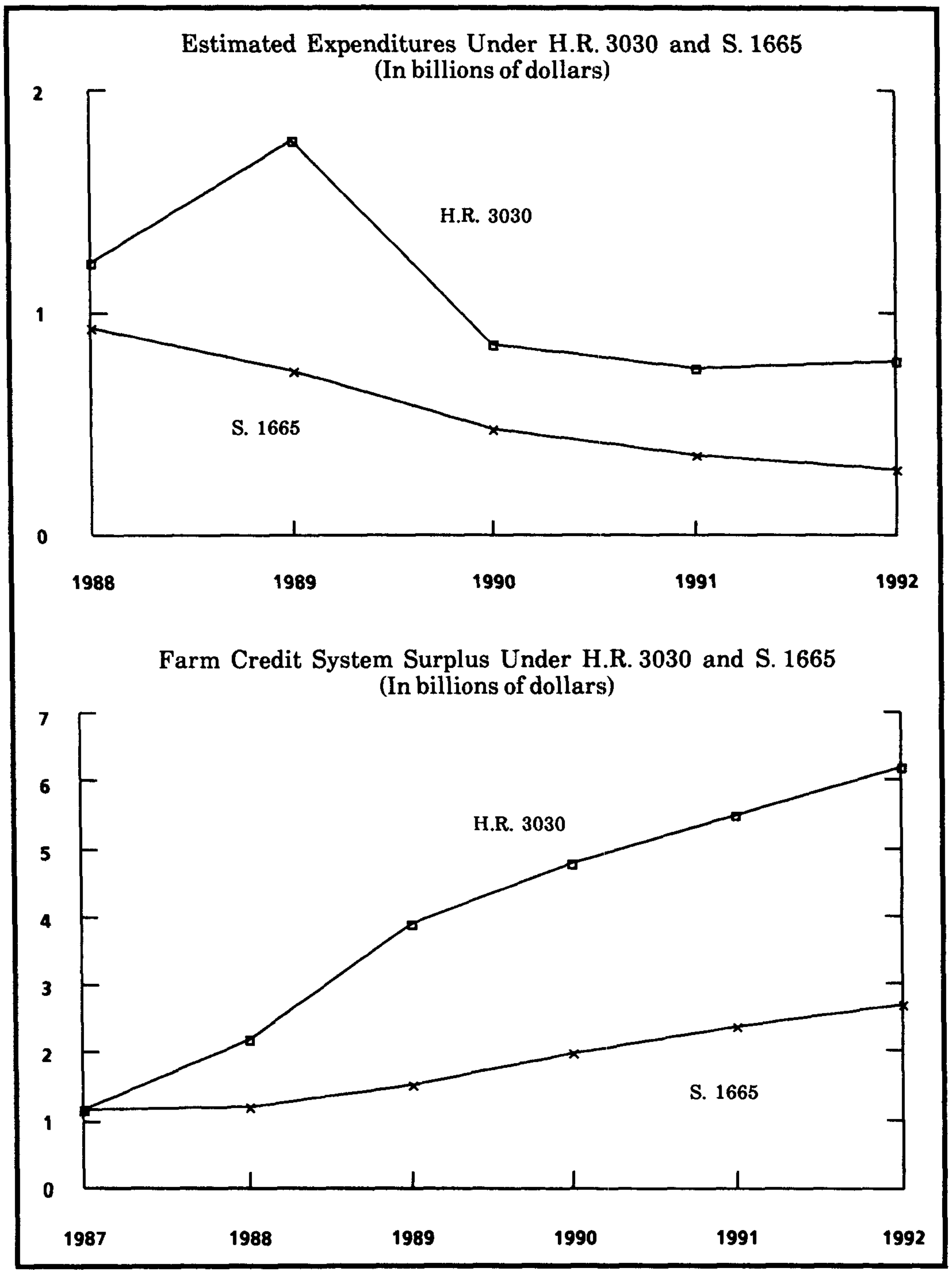
Both bills would provide sufficient assistance to recapitalize the system, though the forms of assistance would differ. The House would incur substantial outlays by appropriating such sums as may be necessary to enable the system to avoid insolvency. The Senate, in seeking to move most of the cost of assistance off the budget, would assist the FCS by means of government guarantees on bonds issued by the system, and provide direct payments tied to the interest expenses of these special bonds; only the direct payments would result in outlays in the early years of the program. This study estimates that in the absence of legislative changes in the structure or operations of the FCS, $2.8 billion will be needed between now and 1992 to avoid insolvency of any part of the FCS.

As shown in the Summary Figure, there is a basic trade-off between the cost of legislation and the financial condition of the FCS at the end of the projection period. The top panel in the figure shows the amount of assistance (either direct as in H.R. 3030 or indirect as in S. 1665) that would be provided to the system. The amount provided under the House bill would be substantially greater than that provided by the Senate bill. In the lower panel of the figure, the amount of earned surplus in the system during the period 1987 to 1992 is plotted for each bill. By 1992, the FCS would have more than twice as much earned surplus under the House bill as under the Senate bill ($6.2 billion under H.R. 3030 versus $2.8 billion under S. 1665). There is a direct correlation between the amount of money spent and the level of earned surplus in the FCS.

The House and Senate bills also address the issue of institutional evolution. Both would permit greater flexibility in merging and liquidating institutions within the system, though the rules governing these institutional changes could reduce the ability to exercise these options. The House bill would mandate a much more significant change in the structure of the system--elimination of the Federal Land Banks and Federal Intermediate Credit Banks. System restructuring could reduce the system's costs by $10 million to $40 million per year, which would reduce the cost of borrowing by between two and seven basis points.

It will be very difficult to strike the proper balance between the social and economic missions of the FCS. The FCS is a cooperative, and a cooperative operates in a slightly different way than does the typical private corporation. A cooperative is owned by its patrons; profit maximization is a less immediate goal; and it is exempt from some of the antitrust rules governing other businesses. The FCS is also an agency lender--meaning that it has certain advantages in raising capital (for example, a partial tax exemption) that are provided by the government. Capital market participants appear to believe that

SUMMARY FIGURE. TWO MEASURES OF THE IMPACT OF H.R. 3030 AND S.1665



agency status means that FCS bonds are backed by an implied government guarantee, even though this is expressly denied by the FCS itself.

Because it is a cooperative, with a number of tangible benefits conferred upon it by the government, the FCS has had more of a social mission than would be expected from a typical lender. If the social mission becomes too costly, however, the FCS will cease to be a competitive source of capital for its members. If it cannot provide capital at a competitive rate, it will fulfill neither its economic nor its social mission. Both the Senate and the House bills expand the social role of the FCS, particularly in the area of borrowers' rights. Borrowers' rights raise a number of equity questions:

- Should FCS borrowers be given rights that other borrowers do not have?
- Is it fair to allow the terms of a contract to be rewritten after the fact?
- Should delinquent borrowers be rewarded by being allowed to renegotiate the terms of their loans?

To the extent that the costs of the FCS increase as a result of borrowers' rights, its competitive position will be eroded. This study estimates that the borrowers' rights in H.R. 3030 could increase the system's costs by up to $190 million per year, or approximately 35 basis points. Borrowers' rights in S. 1665 are somewhat less extensive--system costs could increase by up to $170 million per year or roughly 30 basis points.

In general, the House bill gives much greater weight to the issue of system recapitalization than does the Senate bill. The House bill would commit substantial public resources to an insurance program and to helping the system attain some yet-to-be-determined minimum capital level. The insurance program would increase the FCS's costs by about $80 million per year (or roughly 15 basis points). Minimum capital requirements would mainly affect the Federal Land Banks. The Land Banks might need nearly $900 million in order to meet these requirements, which if paid for by borrowers could add 200 basis points to the cost of borrowing. Other parts of the FCS would be less affected by the minimum capital requirements. The budgetary cost of the House bill would be substantial, in part because of its commitment to system recapitalization; the total cost is estimated by the study at $6.2 billion.

The Senate bill, in contrast, puts the same institutions in place but would not fund them through taxpayer contributions. Because these provisions of S. 1665 are either postponed or do not carry a penalty for failing to comply, they would have almost no impact on the cost of borrowing from the system. Since only direct payments to the FCS would be scored as outlays, the Senate bill would have a much smaller budgetary impact than H.R. 3030--totaling $0.8 billion over the next five years.

THE BUDGET ISSUE

Considering only their budgetary impact, the difference between the House and the Senate bills is substantial. In terms of the capital they would draw from capital markets, however, the difference between them is much less pronounced. The study estimates that the Senate bill would result in the sale of $3.1 billion worth of uncollateralized FCS bonds, which means this amount would be removed from the capital markets. The House plan would require the removal of $6.2 billion from national capital markets, still a substantially greater claim on resources than the Senate bill but a much smaller difference than suggested by their estimated budgetary costs. The practice of moving governmental functions off the budget, in the fashion of the Senate bill, obscures their real economic costs. It also reduces the meaning of the budget as a measure of government's claims on the country's resources.

CHAPTER I

INTRODUCTION

The Farm Credit System (FCS) is a complex, multi-tiered cooperative that is the largest single agricultural lender in the United States. In recent years the FCS has experienced severe financial problems, and in both 1985 and 1986 the Congress passed legislation to assist the system. During 1987 the prospects of the system have improved somewhat: in the second quarter of 1987, the FCS lost only $46 million and in the third quarter it had a positive net income of $4 million. This report examines the FCS's condition in light of the recent improvements and discusses a number of issues raised by pending legislation to assist the system.1/

AN UPDATE OF THE FCS'S FINANCIAL CONDITION

From the FCS's perspective, probably the most important change in the agricultural economy has been the leveling-off of land values. Because land values seem to be bottoming out, particularly in the Midwest, the system has not had to set aside large amounts for loan loss provisions. This, coupled with a slight increase in the volume and value of agricultural exports, relatively good liquidity among farmers (thanks in part to large federal outlays for agricultural programs), and record-high incomes for parts of agriculture (especially livestock producers), has reduced the estimated amount of federal assistance needed.

In 1986, the Congress allowed the FCS to substitute more permissive Regulatory Accounting Practices (RAP) for the standard, and more conservative, Generally Accepted Accounting Practices

1. See Congressional Budget Office, *The Financial Condition of the Farm Credit System*, Staff Working Paper (July 1987), for an earlier analysis of the system's financial problems and past legislative efforts to deal with these difficulties.

(GAAP). RAP regulations permit the FCS to delay the recognition of a portion of certain costs (interest expenses and loan loss provisions) and therefore tend to understate the degree of financial stress in the system. A CBO study in July estimated that the FCS would need between $4.5 billion and $5.4 billion to avoid borrower stock impairment as measured using RAP.2/

Legislation currently being discussed would revoke or render irrelevant the RAP rules, implying that the required amount of federal assistance should be reestimated. This analysis considers the amount of assistance that might be needed to avoid impairment of borrower stock using the more conservative GAAP.

In the absence of any legislative changes in the mandate or structure of the FCS, this study now estimates that between $2.4 billion and $3.4 billion of federal assistance will be needed between 1987 and 1992 if the system is to avert borrower stock impairment under GAAP. No additional transfers between system banks are assumed to occur. The most likely amount of federal assistance needed is estimated to be $2.8 billion. Since this is measured using GAAP rather than RAP, it implies that the projected financial performance of the FCS is much improved. Most of the improvement stems from much lower expectations regarding additions to loan loss provisions and new nonaccrual loans.

The bulk of the assistance will be needed in calendar years 1988 and 1989: between $1.7 billion and $2.0 billion. In large measure these transfers would offset losses that have heretofore been obscured by RAP. Virtually all of the assistance would be for the Federal Land Banks (FLBs), though the Federal Intermediate Credit Banks (FICBs) would receive a relatively small amount (less than $0.1 billion over five years in the most likely case).

2. Stock in the FCS is purchased by farmer borrowers as a condition of their borrowing. Impairing (or reducing the value of) that stock would mean that borrowers would share in the losses experienced by the FCS, a situation the Congress has attempted to prevent.

MAJOR LEGISLATIVE ISSUES

Pending legislation regarding assistance for the FCS has four general themes:

- o Concern that perhaps the FCS needs to be reorganized;
- o Efforts to ensure the stability of the supply of credit over the long term;
- o Interest in borrowers' rights; and
- o Methods of determining the amount, form, trigger point, and delivery mechanism for federal assistance to the FCS.

Restructuring the FCS

The push to reorganize the FCS comes from several sources: a concern about insufficient local input into decisionmaking, concern about the efficiency of the system, and concern about the long-term viability of the FCS.

Local Control. The concern about increasing local participation in decisionmaking, generally referred to as "local control," has some important historical roots. First, the borrower-owned FCS was designed to give farmers more control over their credit supply. There is a widely shared perception that some of this control has been eroded, first by the Farm Credit Administration, a powerful regulator that has not always remained at arm's length from management decisions, and second by the increasing prominence of the district banks. An example of the latter is the 1971 legislation that raised lending limits to 85 percent of the market value of the underlying collateral. Much of the push for this change came from the district banks, which justified the change on the basis of competitive pressures in the more liberal lending environment of the 1970s. Once the limits were raised, local associations were encouraged to use them. These more liberal lending practices are now seen as a major contributor to the system's current financial problems.

A second factor that has made local control a significant legislative issue is the belief that the FCS would like to increase the degree of centralization in the system. In a major study entitled *Project 1995*, the FCS concluded that in order to increase efficiency and assure the system's future competitiveness, a more top-down managerial approach was needed.3/ Since the publication of this study, the system has been actively disowning its conclusions. Nevertheless, some residual concern still exists as to the intentions of the FCS regarding its future structure.

System Efficiency. The efficiency of the system's structure has become a question because of its relatively high overhead expenses. In particular, the system's configuration has become an issue. Currently, the FCS has 12 districts with three banks in each (a Federal Land Bank, a Federal Intermediate Credit Bank, and a Bank for Cooperatives). Given the improvements in communications and transportation that have occurred since the FCS was founded, 12 districts and 36 district banks may not be the best organization for the times. The case for reducing the number of districts would be strengthened if some of the decisionmaking powers were taken from the district banks and given to local associations.

The Long-Term Supply of Agricultural Credit

The Congress has passed legislation dealing with the FCS and its financial problems in each of the past two years. The legislation being considered by the 100th Congress is intended to resolve these problems for the foreseeable future. Resolution of the FCS's problems could take at least two forms. One would be an effort to enhance the long-term viability of the FCS. For example, creating an insurance program and/or minimum capital requirements would strengthen the FCS by enabling it to cope with periodic downturns in the farm economy.

An alternative approach would be to focus on the flow of capital to agriculture rather than on the FCS per se. Currently, the FCS is a major channel through which funds flow to the farm sector from

3. *Project 1995* (Denver, Colo.: Farm Bank Services, June 1984).